

Canadian Taxation of Mining

by Steve Suarez

Reprinted from *Tax Notes Int'l*, December 13, 2010, p. 867

SPECIAL REPORTS

Canadian Taxation of Mining

by Steve Suarez

Mining represents one of the most important sectors of Canada's economy. Mineral extraction within the country has historically been a leading contributor to the nation's wealth, as Canada is fortunate to be endowed with substantial natural resources. Mining has played an important part in the country's evolution into a major developed economy, and Canada is among the world's leading suppliers of uranium, nickel, aluminum, molybdenum, and potash.

Also, Canada is home to hundreds of mining companies with operations principally located outside Canada. The Toronto Stock Exchange (together with its associated junior Venture Exchange) has more listings of mining companies than any other stock exchange in the world,¹ making it the leading source of financing for the mining sector. Canada benefits from the presence of a large community of bankers, lawyers, engineers, and other professionals with deep experience in mining activities. The Canadian legal community in particular has developed expertise in natural resources that is frequently used in structuring and managing mining ventures and assisting other countries in designing and establishing their legal regimes for mining. A stable political environment and strong judicial system with a history of predictably resolving disputes have also contributed to making Canada a desirable place for mining investment, and Canada offers a stable tax regime that is especially favorable for foreign activities of Canadian mining companies.

This article summarizes the Canadian taxation of mining activities. After identifying the different taxes applicable to mining, it goes on to describe the manner in which mining-related expenses are treated for in-

come tax purposes, discuss tax issues of interest to financing of mining in Canada, and provide a synopsis of how foreign activities of Canadian mining companies are treated for tax purposes. Finally, tax considerations relevant to nonresidents investing in Canadian mining will be summarized.

I. Overview

In discussing the manner in which Canada taxes mining operations, it is helpful to start with a general overview. Relevant taxes arise at both the federal (national) level and within each of the 10 provinces and three territories of Canada. (For discussion purposes, references to provinces will include the territories.)

A. Federal Income Tax

Federal income tax is levied under the Income Tax Act (Canada). Residents of Canada are subject to Canadian income tax on their worldwide income. Income from each separate source (for example, a business, investment, or employment) is calculated, and tax owing is determined as the applicable percentage of total taxable income. Natural persons pay tax on a graduated or progressive basis, while corporations generally pay tax at a single or flat rate. The general rate of federal income tax on active business income earned by a corporation for 2010 is 18 percent, dropping to 16.5 percent for 2011.²

Income is determined for each year on an accrual basis; that is, income and expenses are recognized as they are earned or incurred, rather than when received or paid. Income items are fully includable in (or for

¹ See http://www.tmx.com/en/pdf/Mining_Sector_Sheet.pdf.

² For a list of relevant tax rates, see <http://www.cra-arc.gc.ca/tx/llrts/menu-eng.html>.

expenses, deductible from) the taxpayer's taxable income. Conversely, only 50 percent of capital gains are included in income and subjected to tax, and expenses that are capital in nature are generally not deductible in computing income. (See Section II of this article.) Excess business losses from a given year may be carried back and used in the three immediately preceding tax years or carried forward up to 20 years following the year of the loss.

Nonresidents of Canada are subject to Canadian income tax on:

- income from carrying on business in Canada;
- income from employment in Canada; and
- capital gains realized on disposing of some forms of Canadian-situs property (taxable Canadian property).

If they engage in these activities and no applicable tax treaty applies to provide relief, in general they compute their income from (and pay tax on) these Canadian activities in essentially the same manner as described above. "Taxable Canadian property" includes land in Canada (or an interest therein), Canadian natural resource properties, and shares of a corporation or interests in a partnership that derive more than 50 percent of their value (directly or indirectly) from land or natural resources in Canada at any time during the immediately preceding five years.

Nonresidents are also subject to Canadian withholding tax (also called Part XIII tax) on payments of passive, investment-type income from Canada. The most prominent examples of income subject to Part XIII tax if the payor is a Canadian resident are dividends, interest (if paid between non-arm's-length persons or if the interest is participating interest), rents, and royalties. The rate of tax is 25 percent of the gross amount of the payment (no deductions permitted).

Nonresidents of Canada who reside in a country with which Canada has a tax treaty may be entitled to relief from Canadian income or withholding tax, as tax treaties take precedence over the ITA. For example, Canadian tax treaties generally lower the rate of withholding taxes on passive income and prevent Canada from taxing Canadian-source business income unless earned through a Canadian permanent establishment of the nonresident.³

B. Other Taxes

Income subject to federal income tax will generally also be the subject of income tax in whichever provinces the income relates to. In very general terms, income is allocable to a province if it is earned through a PE within the province. Provincial income tax is essentially computed on the same basis as federal income

tax, with some variations (for example, British Columbia has a separate mining exploration tax credit and Ontario has a notional resource allowance). Rates of corporate provincial income tax vary from province to province, ranging from 10 percent in Alberta to a high of 16 percent in some provinces in Atlantic Canada, meaning that combined federal/provincial corporate income tax rates range from roughly 28 to 34 percent for 2010.

Most provinces also levy a separate tax on mining operations conducted within the province, ostensibly as compensation for the depletion of nonrenewable mineral resources. There are significant variations in the manner in which these provincial levies are computed. For example, there are provinces that tax some minerals and not others, and in some cases a specific tax applies only to particular minerals (for example, Saskatchewan has a distinct set of rules for taxing potash). Provincial mining taxes typically impose a tax on the pit's mouth value of output from a mine (that is, excluding subsequent value added from processing), with deductions permitted for mine development and mineral extraction costs. Provincial mining taxes are generally deductible for income tax purposes.

For example, Ontario levies a tax of 10 percent on profits from operating a mine within Ontario in excess of \$500,000 (5 percent for mines in remote areas). Profit is determined by taking the sale price of mine output (including proceeds from hedging activity) and subtracting exploration and development expenditures, an allowance for processing, transportation costs, and a depreciation allowance. An exemption of up to \$10 million for profits from a new mine is permitted.⁴

Canada also has a 5 percent value added tax (the goods and services tax) comparable to VATs found in Europe. Each taxable supply of goods or services attracts the GST, and businesses are permitted to claim input tax credits to recover GST paid on the cost of their inputs, so that the tax is borne only by the ultimate end user. Some businesses (most notably financial services) do not charge GST on their outputs and cannot claim input tax credits, so they bear any GST that they pay. Most (but not yet all) Canadian provinces have now harmonized their sales taxes with the federal GST, at rates ranging from 0 (Alberta has no sales tax) to 10 percent.

Mining operations will generally pay GST on their inputs (which will be recovered via input tax credits) and charge GST on their output. As such, in most cases sales taxes are essentially a compliance and cash flow issue for them. In general no GST applies to mining-related royalties.

³For a list of Canadian tax treaties, see http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp.

⁴A detailed discussion of provincial mining taxes can be found in Gamble, *Taxation of Canadian Mining*, Carswell (loose leaf), a leading resource on Canadian mining tax.

Table 1. Overview of Canadian Taxes on Mining

Tax	Principal Features
Federal Income Tax	<p>Canadian residents taxable on worldwide income; foreign tax credits for foreign-source income.</p> <p>Income computed for each “source”; certain deductions permitted in computing “taxable income”; applicable tax rate then applied to determine tax payable.</p> <p>Subject to treaty relief, nonresidents subject to:</p> <ul style="list-style-type: none"> withholding tax on Canadian-source passive income; and normal income tax on Canadian-source business income and some capital gains.
Provincial Income Tax	Generally computed the same as federal income tax (lower rates), subject to some differences.
Provincial Mining Tax	Significant variation among provinces, but generally levied as a percentage of value of mine output; deductible for income tax purposes.
Other Taxes	5 percent federal GST tax; most provinces levy a corresponding (harmonized) sales tax; payroll and land transfer taxes exist; corporate capital tax largely eliminated; no stamp duty.

Canada also has federal and provincial payroll taxes, as well as land transfer taxes at the provincial level. Corporate capital taxes have largely been eliminated in Canada other than for financial institutions, and there is no stamp duty in Canada. (See Table 1.)

II. Treatment of Mining Expenditures

One of the most important elements of the Canadian taxation system’s approach to mining is the treatment of expenditures. The tax treatment of these items is especially important because mining is highly capital intensive and requires substantial early-stage expenditures.

Most significant expenditures on mining exploration, development, and production in Canada (other than financing expenses and day-to-day operating expenses) fall into one of three categories for Canadian income tax purposes:

- the cost of capital property that is depreciable property⁵;
- Canadian exploration expense (CEE); or

⁵For mining, nondepreciable capital property is largely limited to shares of corporations and interests in partnerships.

- Canadian development expense (CDE).

The primary attributes of these concepts (which do not apply to some industrial minerals such as gravel and limestone) are discussed below and are summarized in Table 3.

A. Depreciable Property

Expenditures of a capital nature on certain kinds of property (depreciable property) are the subject of capital cost allowance (CCA), which is essentially the Canadian tax version of the accounting concept of depreciation. Most buildings (but not land), machinery, and equipment are common examples. For Canadian tax purposes, depreciable properties are grouped into different classes, with each class having its own separate rate of CCA. When a taxpayer acquires a depreciable property of a particular class, the cost of that property is added to the pool of expenditures made by the taxpayer for depreciable property of that class (the undepreciated capital cost (UCC) of that class). Each year in computing income, the taxpayer is entitled to deduct a percentage of the remaining UCC of that class. The UCC of the class is then reduced by the amount of that year’s CCA deduction. Sale proceeds from dispositions of depreciable property (not exceeding the taxpayer’s original cost of the property) also reduce the taxpayer’s UCC of the relevant class of property. A negative year-end UCC balance is included in income.

A simplified example of the operation of the CCA system is set out in Table 2 using a class of property with an assumed CCA rate of 25 percent.

Table 2. CCA Example

	Year 1	Year 2
Start-of-year UCC balance	\$500,000	\$600,000
+ Property acquired in year	\$300,000	\$100,000
- Property disposed of in year (up to original cost)	nil	<u>\$300,000</u>
= Year-end UCC balance	\$800,000	\$400,000
CCA deduction claimed (25%)	\$200,000	\$100,000
Remaining UCC balance	\$600,000	\$300,000

For property acquired after 1987 for use in a mining operation, class 41 is the CCA class most commonly encountered. Property in class 41 includes property acquired after 1987 principally to produce income from a mine in Canada operated by the taxpayer, and that is:

- most buildings or other structures, machinery, and equipment (excluding an office not at the mine site and property used for processing another taxpayer’s ore);

- power generating and distributing equipment and plant used in operating a mine, ore mill, smelter, or refinery;
- railway track and ancillary equipment and machinery (but not rolling stock) used to earn income from a mine;
- so-called social assets: property used to provide services to the mine or to a community where a substantial portion of the mine's workforce resides (for example, hospitals, houses, roads, or recreational facilities); and
- property designed principally to explore for minerals.

The applicable CCA rate for class 41 property is generally 25 percent. However, in some circumstances the taxpayer is entitled to claim a deduction of up to 100 percent of the UCC of some class 41 properties (not exceeding income from the mine). Generally, this 100 percent rate applies for property acquired before the mine came into production or as part of a significant expansion of a mine. This accelerated CCA is meant to offset some of the risk of investing in new mines, by effectively deferring taxation of mine income until the cost of its capital assets has been recovered out of project earnings.

B. Canadian Exploration Expense

When an expenditure (current or capital) does not constitute the cost of a depreciable property, it may fall within a category of expenses unique to the Canadian tax regime for the natural resource industry. Some expenditures relating to resource properties (including mines) constitute CEE and are included in the taxpayer's cumulative CEE (CCEE) pool balance.

CEE encompasses most exploration and preproduction development expenses other than for depreciable property. CEE includes the following expenditures:

- *Exploration:* Expenses incurred to determine the existence, location, extent, or quality of a mineral resource in Canada, including in the course of prospecting, geological/geophysical/geochemical surveying, drilling, trenching, digging test pits, or sampling. Any such expenses related to a mine already producing in commercial quantities⁶ (or any extension of such a mine) or included in CDE (see below) are excluded.
- *Preproduction:* Expenses incurred for the purpose of bringing a new mine into production in reasonable commercial quantities (including expense for clearing, removing overburden, stripping, sinking a

mine shaft, or constructing an adit or other underground entry), if incurred *before* the mine comes into production in reasonable commercial quantities.

Each year, any CEE incurred by the taxpayer is added to its CCEE. At the end of the year, the taxpayer is entitled to claim a deduction in computing income up to the full amount of the taxpayer's year-end CCEE balance, not exceeding the taxpayer's income for the year (a lesser amount may be claimed if desired). Any unclaimed CCEE balance (reduced by the deduction claimed) is carried forward to the next tax year, much like a UCC balance (other amounts, such as government subsidies, also reduce CCEE). If for any reason the CCEE balance is a negative amount at year-end (that is, cumulative reductions exceed additions), that negative amount is added to the taxpayer's income for the year and the CCEE balance is reset to zero.

C. Canadian Development Expense

Other resource-related expenditures are treated as CDE and added to the taxpayer's cumulative CDE (CCDE) or pool balance. CDE includes the cost to the taxpayer of a Canadian resource property, which for mining would be:

- any right, license, or privilege to prospect, explore, drill, or mine for minerals in a Canadian mineral resource;
- any royalty or rental computed by reference to the production from a Canadian mineral resource that the payer has an interest in; or
- any interest in Canadian real property the principal value of which is dependent on its mineral content.

Also included are postproduction mine development costs, being any expense incurred in sinking, excavating, or extending a mine shaft, main haulage way, or similar underground work for continuing use in a Canadian mineral resource (except to the extent included in the cost of depreciable property), if built *after* the mine has come into production. The cost of depreciable property is excluded from CDE.

Qualifying CDE expenditures described above are added to the taxpayer's CCDE balance, while the proceeds for any Canadian resource property sold during the year are subtracted. In computing income in any year, the taxpayer is entitled to deduct up to 30 percent of the year-end CCDE balance (a lesser amount may be claimed if desired). Any unclaimed CCDE balance (reduced by the deduction claimed) is carried forward to the next tax year, as with CCEE. If for any reason the CCDE balance is a negative amount at year-end (that is, cumulative reductions exceed additions), that negative amount is added to the taxpayer's income for the year and the CCDE balance is reset to zero. This might occur if a mining property is sold during the

⁶This requirement has generated much jurisprudence on whether a particular mining operation constitutes a "new mine" or the continuation of an existing one. The CRA's administrative practice is that a mine has reached production in reasonable commercial quantities when it has operated at 60 percent capacity or more for 90 consecutive days.

Table 3. Summary of Canadian Mining Expenses

	Class 41 Depreciable Property	CCEE	CCDE
Costs included	<p>Most buildings, machinery, and equipment used to earn income from a mine</p> <p>Power generation and distribution equipment to supply a mine</p> <p>Social services assets to support a mine or mining community</p> <p>Railway track and ancillary equipment and machinery used to earn income from a mine</p> <p>Property designed to explore for minerals</p>	<p>Expenses to determine existence, quality, etc. of mineral resource in Canada (prospecting, surveying, etc.), unless mine already in commercial production</p> <p>Preproduction expenses incurred to bring mine into commercial production</p> <p>Excluded: depreciable property</p>	<p>Costs to acquire or preserve Canadian resource property (right to prospect mine minerals in Canada, royalty in Canadian mineral resource, interest in land in Canada dependent on mineral content)</p> <p>Expense of sinking or excavating a mine shaft or underground work in Canadian mineral resource, if incurred after mine in production</p> <p>Excluded: depreciable property</p>
Balance reduced by	<p>CCA deductions claimed</p> <p>Sale proceeds of class 41 property (up to original cost)</p>	CEE deductions claimed	CDE deductions claimed
Deduction rate (on year-end balance)	25 percent (100% in some cases)	100% (up to income)	30 percent
Expense eligible for flow-through share renunciation?	No	Yes	Limited (and not grassroots-eligible)
If incurred by partnership	Deduction claimed by partnership	Deduction claimed by partners	Deduction claimed by partners
Costs eligible for ITC?	No	Yes (if relating to base or precious metals or diamonds)	No

year for proceeds of disposition exceeding the taxpayer's CCDE balance, for example.

D. Investment Tax Credits

Some mining exploration expenditures in Canada entitle Canadian mining corporations to an investment tax credit. As opposed to a deduction from income, a tax credit is a dollar-for-dollar reduction in actual tax payable, making it particularly valuable. A 10 percent ITC applies for preproduction exploration and development CEE relating to base and precious metals and diamonds (that is, \$100 of qualifying CEE generates a \$10 tax credit). The amount of the ITC is subtracted from the corporation's CCEE in the following year.

E. Reclamation Obligations

Mining activities are typically subject to regulations requiring the mine site to be restored at the end of the mine's life. While ongoing expenditures incurred on a year-by-year basis are generally deductible, under Canadian tax law there is no deduction for an obligation to do something unless expenses are incurred toward meeting that obligation, as reserves are not deductible under the ITA unless permitted by the statute. While the ITA includes provisions for some forms of funded reclamation trusts, in practice these are not commonly used.

To the extent that expenditures toward meeting reclamation obligations are in fact incurred, the better view is that they should be considered part of the income-earning process since they arise in the course of income-earning activities, even if incurred at a time when income from the mine has diminished or ceased. As such, they should be deductible from income in the year incurred, and (to the extent exceeding such income) available to be carried back up to three prior tax years and used against income from those earlier years under the normal rules dealing with loss carrybacks.

III. Financing and Development

Financing is the lifeblood of mining, since most companies are unable to finance new projects from existing cash flow and mining is a particularly capital-intensive form of investment, with projects often taking many years. Tax is a critical factor in how Canadian mining is financed.

A. Debt vs. Equity

The basic choices for investing in a corporation are through equity (that is, shares) of the corporation or debt. Whether a particular security is debt or equity for Canadian tax purposes follows from how it is characterized for purposes of the relevant corporate/

commercial law. There is no economic substance doctrine in Canadian tax law that would ignore a security's legal character based on its economic characteristics.

A corporation may make distributions on its shares as a return of share capital (to the extent of such share capital) or as dividends, which in either case are not deductible to the corporation in computing its income for tax purposes. Canadian-source dividends are taxable to Canadian residents at rates that depend on the type of dividend and the identity of the recipient, but are generally lower than the full rate of tax applicable to most forms of income. In most cases, Canadian corporations can receive dividends from other Canadian corporations without tax under a 100 percent dividends received deduction. Nonresidents are typically subject to a 25 percent withholding tax on Canadian-source dividends, which for residents of treaty countries is usually reduced to 15 percent or less under virtually all Canadian bilateral tax treaties (many of which provide for a 5 percent rate when the dividend recipient owns 10 percent or more of the paying corporation's equity). An amount received as a share capital return on a Canadian corporation's shares is generally not taxable when received (since from the payer's perspective it represents a return of contributed capital), although the shareholder's cost basis in the shares is reduced by that amount. If the capital reduction exceeds the shareholder's basis in the shares, the excess is deemed to be a capital gain.

A debt investment yields interest income. Interest paid by a debtor on money borrowed (or purchase price owing for property acquired) for use in a business is generally deductible, subject to limitations described in Section III.B below. Interest received by a Canadian resident is taxed at normal rates; that is, less favorably than dividends. Interest paid to a nonresident is subject to Canadian interest withholding tax only if either the creditor and debtor do not deal at arm's length or the interest is participating (that is, contingent or dependent on revenue or profits). When nonresident interest withholding tax does apply, the rate is 25 percent unless reduced under an applicable tax treaty. Most Canadian tax treaties reduce the interest withholding rate to 10 or 15 percent, and the Canada-U.S. treaty eliminates withholding on non-arm's-length interest (except participating interest).

B. Deduction of Interest Expense

Debt may be an attractive alternative when there is likely to be enough Canadian-source taxable income in the foreseeable future to use an interest expense deduction. Interest expense incurred on debt legally owing and incurred for use in a business or investment is generally deductible in computing the debtor's income for Canadian income tax purposes. Canada follows a tracing method of deductibility, requiring the debtor to show that the borrowed money (or in the case of debt that is unpaid purchase price for property acquired, the property) was and continues to be used in the business.

Some limitations on interest deductibility may apply in any given situation. Because interest expense is a relatively simple way of stripping profits out of Canada, a thin capitalization regime limits interest expense deductibility on debts owing by a Canadian corporation to some nonresidents if they exceed a specified debt-equity ratio. This rule is directed at debt owing to "specified nonresidents," being nonresidents who either are 25-percent-plus shareholders (by votes or value) of the corporation or who do not deal at arm's length with such 25-percent-plus shareholders. To the extent that the corporation owes money to specified nonresidents in excess of twice the sum of the corporation's total retained earnings plus the paid-up capital attributable to shares of the corporation owned by nonresidents who are 25-percent-plus shareholders, the corporation cannot deduct interest on the excess debt. No thin capitalization restriction applies to debt owing to other creditors.

Interest expense in excess of a "reasonable" amount is not deductible, meaning that interest in excess of a market or arm's-length rate will not be deductible. Moreover, while interest expense generally is deductible when it accrues (rather than when it is paid), if interest owing to a non-arm's-length creditor remains unpaid at the end of the second tax year following the year in which the expense was incurred, it is added back to the debtor's income.

C. Production-Based Financing

Canadian mining corporations have developed a number of ways of securing financing based on effectively monetizing future mine output (Canadian or foreign) in one form or another. Older forms of output-based financing include so-called gold loans, in which the mining corporation borrows an amount of the relevant metal (gold, for example) from a bank and sells the borrowed property for cash to finance mine development or refinance existing indebtedness. The mining corporation assumes an obligation to make annual payments while the loan is outstanding and to deliver out of its future production an amount of the relevant metal equivalent to the original amount borrowed.

More recent varieties of this kind of transaction involve similar sorts of forward sales, in which a purchaser seeking a long-term stream of a particular metal agrees with a mining corporation to make an immediate payment (usually structured as a deposit) to the mining company in exchange for receiving future production at a set price typically well below the current spot price. A number of these transactions have occurred involving Canadian miners, often when the metal in question is a byproduct of operations to mine a different metal (for example, silver recovered from a gold mining operation). The mining corporation is required to include the upfront payment in income for

tax purposes, but it claims an offsetting reserve permitted by the ITA for property deliverable in a later year. There are multiple variations on this concept, which continues to evolve.⁷

D. Royalties

Another way of financing mining activities is to sell an interest in the underlying property or its production in order to fund production and development. The term “royalty” is a broad one and may encompass various forms of interest in a mine’s production and be computed many different ways. For example, a net smelter royalty is typically thought of as one in which only a relatively limited number of costs or expenses are deducted from production proceeds in determining the royalty holder’s entitlement, whereas a net profits royalty is one in which virtually all costs of production are deducted in computing the royalty.

In most cases the acquisition of a royalty interest relating to a Canadian mining property will result in an addition to the acquirer’s CDE pool equal to the amount paid for the royalty. (See Section II.C of this article.) A Canadian-resident royalty holder will be taxable in Canada on royalty income from production and may claim CDE deductions over time under the normal rules. Nonresident royalty holders are often taxed disadvantageously, however, as they are generally subject to 25 percent nonresident withholding tax on the royalty and Canada’s tax treaties generally do not provide for a reduction in taxation of resource-related royalty income. CDE deductions are not relevant to a nonresident who is subject to withholding tax, which is a tax on the gross amount of the payment; only if the royalty is held as part of a business carried on in Canada by the nonresident so as to make the nonresident liable for Canadian income tax will CDE deductions (or any other deductions from income) be relevant.

The mining corporation disposing of the royalty interest will have a reduction in its own CDE in the amount of the sale proceeds. Ongoing royalty payments to the royalty holder will generally be deductible in computing the corporation’s income.

E. Farm-Outs

An exploration and development financing technique common in the resource industry is the farm-out. Under a farm-out, the owner of the resource property (the “farmor”) grants an interest in the property to another party (the “farmee”) who has capital available and agrees to carry out exploration or development

work on the property, thereby earning an interest in the property. The extent of the interest retained by the farmor and acquired by the farmee depends on whatever agreement the parties reach, and there are many variations on the concept. In mining, a farm-out might occur when, for example, a prospector or junior exploration company has made a discovery of interest and lacks the financial resources or expertise to prove or develop the claim.

There are no specific provisions in the ITA dealing with farm-outs, which are essentially governed by Canada Revenue Agency administrative policy. The CRA has described common farm-out arrangements that do not, in its view, create proceeds of disposition for the farmor:

- A simple farm-out, whereby the farmor transfers an interest in an unproven resource property (that is, there are no proven reserves regarding the resource property) to the farmee in exchange for which the farmee will perform and pay for exploration and development services on the property.
- A typical farm-out, in which the farmor transfers all of the working interest in an unproven resource property to the farmee in exchange for a royalty interest in production from the property, and the farmee funds exploration and development work on the property. After the farmee recovers these costs, a portion of the working interest reverts back to the farmor.
- A widespread farm-out, in which the farmor transfers unproven resource property to the farmee in exchange for work done on a different unproven resource property of the farmor.

In those cases, the farmee should be considered to have incurred CEE on qualifying exploration expenditures (that is, rather than being treated as having incurred CDE) and should have a zero cost in its interest in the property. As importantly, the farmor will not be considered to have received proceeds of disposition. This favorable CRA view, made regarding oil and gas transactions, is generally applicable to the mining industry as well.⁸ The key factor in the CRA’s administrative position is that the farmor’s resource property is unproven.

F. Partnerships and Joint Ventures

Another way in which many mining projects obtain the financing they require is through the collaboration of different mining companies. Partnerships and joint ventures are two common ways in which such collaboration occurs.

Under Canadian law, a partnership requires that two or more persons (the partners) carry on business in

⁷For more on this topic, see Colborne and McLaren, “Alternative Financing Through Forward Sales,” Canadian Mining Law and Finance Conference, June 14 and 15, 2009, Cambridge International Forums Inc.; and Colborne and Ruus, “2010 Mining Update,” in 2010 Annual Conference Report, Canadian Tax Foundation (forthcoming).

⁸See the closing sentence of paragraph 14 of Interpretation Bulletin IT-125R4, and CRA documents 2007-0262881R3 (Dec. 3, 2008) and 2005-0119731E5 (June 15, 2005).

common with a view to a profit. Canadian law provides for both general partnerships (in which all partners have full liability for the activities of the partnership) and limited partnerships. In a limited partnership, the general partner actively manages the business and has full liability for the activities of the partnership, while the limited partners are not actively involved in the business of the partnership and are not liable for the partnership's activities beyond their investment in the partnership.

In general terms, for Canadian tax purposes a mining partnership is treated as owning the property used in and earning the income generated by the mining operation; that is, the partnership is treated as a taxpayer for purposes of computing income. However, the partnership itself does not pay tax. Instead, the partnership's income (net of deductions such as CCA) is then attributed to the partners whether or not the partnership makes any distributions to them. The partners themselves are then able to claim a number of important deductions in computing their taxable incomes (for example, CEE and CDE incurred by the partnership are deducted separately by the partners), and are liable to pay income tax on any remaining taxable income.

As such, partnerships are often attractive from a tax perspective because for Canadian tax purposes they are treated as transparent or flow-through entities — instead of the partnership being taxed, the income earned by the partnership is treated as having been earned by the partners themselves, and taxed in their hands. Partnerships thereby involve one layer of tax (at the partner level), not two (as with a corporation and its shareholders). Partnerships are also useful tax vehicles because they are flexible, being largely governed by whatever contractual agreements the partners choose to put in their partnership agreement.

A common use of partnerships in mining is when an exploration company with a promising project but lacking financing transfers its interest in the property into the partnership in exchange for an interest in the partnership. The transfer can be structured to move significant CEE/CDE balances into the partnership, if desirable.⁹ The other partner (often a larger mining company) contributes cash to the partnership to fund development work.

Joint ventures are not themselves legal entities. They really represent a contractual arrangement between two or more persons, usually for a specific project, whereby the parties each agree to contribute money, property, or

services and to share the resulting output and liabilities. A joint venture is not considered to be a separate entity either for legal or tax purposes. Instead, the joint venturers each pay tax on their shares of revenues and expenses generated by the joint venture's operations. In mining joint ventures, the joint venturers typically appoint one party (usually the party with the greatest financial interest) to act as their agent in managing and operating the project for them. Each joint venturer still reports his own share of the revenues and expenses of the joint venture for tax purposes.

G. Flow-Through Shares

Flow-through shares (FTS) are a form of equity financing that is unique to the resource sector in Canada. In essence, FTS are a financing tool available to a Canadian resource corporation that allows it to issue new shares to investors at a higher price than it would receive for normal shares, thereby assisting it in raising money for exploration and development. Investors are willing to pay a premium for FTS, because they acquire (and can deduct) some of the issuing corporation's CEE (and in some cases CDE), thereby reducing their Canadian taxes. Essentially, the investors and the corporation agree that the investors will purchase FTS from the corporation, the corporation will incur expenditures on CEE within a specific period, and the corporation will renounce that CEE in favor of the investors, for their use. While CEE renounced by the corporation cannot be deducted by it, typically FTS financings are used by resource companies that do not have taxable income and therefore have no immediate need for the CEE renounced to FTS investors.

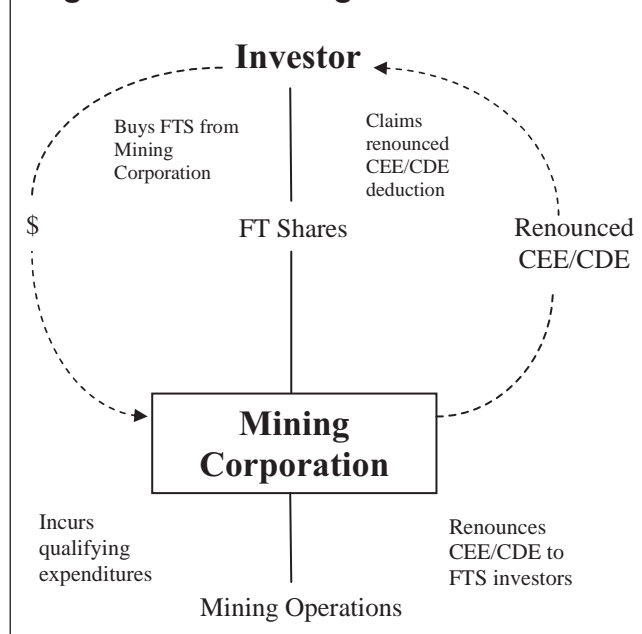
FTS are a useful financing tool for the resource industry in Canada, because they represent one of the few ways in which one taxpayer is able to effectively transfer its tax deductions to an arm's-length person. An FTS structure is illustrated in Figure 1.

1. Requirements

While the rules governing FTS are somewhat complex, the key requirements for the issuance of FTS by a mining corporation to investors are:

- the principal business of the mining corporation must be mining or exploring for minerals (processing of metals or minerals is also permitted);
- the FTS that investors subscribe for must be ordinary common shares that do not (either under the share terms or any agreement) guarantee any return or reduce the risk of loss associated with holding common shares of the mining corporation; and
- the subscription agreement between the mining corporation and the FTS investors must provide for the mining corporation to incur the qualifying CEE expenditures during a permitted period and renounce those expenditures to the FTS investors by a specific date.

⁹A partnership composed exclusively of Canadian partners is entitled to avail itself of some rollover provisions in the ITA allowing it to acquire property on a tax-deferred basis in exchange for an interest in the partnership. Partners are not considered to own the partnership's property for tax purposes; instead they are considered to own a separate property that is their interests in the partnership, and they may realize a gain or loss from the sale of that partnership interest.

Figure 1. Flow-Through Share Illustration

Under the most common form of FTS transaction, the mining corporation incurs “grassroots” CEE, which are expenses incurred to determine the existence, location, extent, or quality of a mineral resource in Canada, including in the course of prospecting, geological/geophysical/geochemical surveying, drilling, trenching, digging test pits, or sampling. Other forms of CEE (that is, preproduction development expenses) and some kinds of CDE are only eligible for a less advantageous form of FTS transaction that is relatively uncommon and not discussed in this article. The cost of depreciable property is never FTS eligible.

In a grassroots FTS financing, the mining corporation enters into an FTS subscription in one year (for example, 2010) and incurs grassroots CEE any time in the immediately following calendar year (2011). The investor pays for the FTS under that agreement before the end of 2010. When this occurs, the mining corporation may renounce the grassroots CEE to the FTS investors during the first three months of 2011 *effective as of December 31, 2010*, allowing the investors to deduct the renounced CEE in 2010. Hence, the grassroots CEE is available to be deducted by FTS investors *before* the mining corporation actually incurs it.

2. Benefits

Persons who subscribe for FTS (that is, original purchasers from the mining corporation, not subsequent purchasers) may obtain various tax benefits from the shares. Most importantly, the FTS investor can deduct the CEE renounced to it from its income for federal and provincial tax purposes. The resulting tax savings will depend on the rate of tax applicable to the particular FTS investor, but for most investors the savings will

be substantial. The FTS investor is deemed to have zero cost in the FTS for tax purposes, meaning that on a subsequent sale of the FTS the entire sale proceeds will be treated as a capital gain. However, since only 50 percent of capital gains are included in income (and only then when the share is sold), the net tax benefit is still quite significant.

Second, FTS investors who are natural persons (not corporations) may also be entitled to an ITC equal to 15 percent of certain qualifying expenditures flowed through to them under FTS. Each \$1 of ITC reduces an investor's taxes owing by \$1. In general terms, the expenses that qualify for this so-called super-flow-through tax benefit are those included in CEE incurred before 2012 in conducting mineral exploration activity from or above the surface of the earth to determine the existence, location, extent, or quality of a mineral resource other than coal (some preliminary sampling expenses are excluded). Note that the ITC reduces the investor's CCEE balance in the subsequent tax year.

Moreover, some provinces (Ontario, British Columbia, Saskatchewan, and Manitoba) go further and offer analogous ITCs for provincial income tax purposes regarding comparable grassroots exploration activity carried out within the province. Quebec offers additional deductions from income instead of a tax credit. Provincial ITCs reduce the amount of the federal ITC and (as with federal ITCs) are deducted from the investor's CCEE in the subsequent tax year. These tax benefits make flow-through shares a useful financing tool for mining corporations.¹⁰

IV. Foreign Activities

Canada is home to hundreds of mining corporations with foreign mining activities, in part because of a relatively generous controlled foreign corporation regime in the ITA that makes it favorable to use a Canadian corporation as the top-tier entity in an international mining group. While the rules dealing with Canadian taxation of foreign-source income (and mining income in particular) are fairly complex, they are summarized at a general level below.

A. Foreign Branches

It is uncommon for Canadian mining corporations to carry on mining operations outside Canada directly (as opposed to through a foreign subsidiary), both for tax and nontax reasons. For example, a separate entity resident in the country of operations may offer reduced commercial liability, may be treated advantageously under local law (which sometimes restricts natural resource exploitation to local entities), and will usually offer more flexibility in terms of tax planning (both

¹⁰For a more detailed discussion of flow-through shares, including a simplified numerical example of the benefits to investors, see <http://miningtaxcanada.com/flow-through-shares/>.

during operations and on eventual sale). In particular, using a separate foreign entity may allow deferral or exemption of Canadian taxation on operating profits. (See Section IV.B below.)

If a Canadian corporation does operate directly in a foreign country, Canada will tax the Canadian corporation on foreign income earned, subject to any relief provided under a tax treaty between Canada and that country. Moreover, Canada will typically offer a foreign tax credit for foreign income or profits taxes paid on foreign-source income, reducing Canadian tax owing by the amount of foreign taxes paid on the same foreign income. Most foreign mining expenditures will be treated as “foreign resource expenses” (roughly a foreign counterpart to CDE), which the taxpayer may deduct at a relatively low rate of 10 percent per year (up to 30 percent if there is mining income from the country of operations). These expenditures are tracked on a country-by-country basis.

B. Foreign Subsidiaries

In most cases it is advantageous for a Canadian mining corporation to carry on business outside Canada through a separate corporation that is not resident in Canada for tax purposes. Establishing foreign fiscal residency requires that the corporation be created under the laws of the relevant foreign country (not Canada or a province thereof) and that its “central management and control” be located in that foreign country.¹¹

Canada’s rules for taxing income earned by foreign subsidiaries of Canadian corporations may be described at a very general level as follows:¹²

- *The FAPI System:* An antideferral regime applies to passive income (foreign accrual property income) earned by a foreign corporation in which a Canadian resident is a direct or indirect shareholder and which is controlled by the Canadian resident (itself or by non-arm’s-length persons). FAPI earned by such a corporation (a controlled foreign affiliate) is treated as if it had been earned by the Canadian taxpayer, such that Canadian tax applies immediately whether or not such income is actually distributed to the Canadian taxpayer.
- *The Surplus System:* Canada has a separate set of rules dealing with how to tax distributions made to a Canadian resident by one of its foreign affiliates (FAs) — essentially foreign corporations in which the Canadian has at least a 10 percent direct or indirect interest. The surplus rules either

exempt the distributions from Canadian tax or provide appropriate recognition for the foreign tax that the FA’s income has borne.

Both sets of rules are based on the distinction between active business income (ABI) and passive income. ABI generally includes income from most business operations and some intragroup amounts that might otherwise be considered passive income but that relate to ABI earned by another member of the corporate group (for example, interest on money loaned by one group member to another member for use in an active business carried on by the borrower). Passive income includes income typically thought of as such (for example, interest, dividends, rents, and royalties), excluding recharacterized passive income described in the preceding sentence and dividends from other FAs of the Canadian taxpayer. Also included in passive income is income from some businesses when they engage fewer than six full-time employees or relate principally to Canada.

In summary, ABI is never considered FAPI, while passive income is treated as FAPI and if earned by an FA controlled by the Canadian taxpayer (or related persons), it will be imputed to the Canadian taxpayer and taxed currently.

The surplus system differentiates between countries with which Canada has an income tax treaty or tax information exchange agreement (a treaty country) and those that don’t. ABI earned in a treaty country by an FA that is also resident in a treaty country will be characterized as exempt surplus. Such amounts may be repatriated (that is, paid as a dividend) to the Canadian taxpayer free of Canadian tax. Otherwise, the ABI is characterized as taxable surplus, and when repatriated to Canada will be subject to Canadian income tax with credit given for underlying foreign tax paid by the relevant FA on the income. These principles are summarized in Table 4.

The treatment of capital gains is also determined with reference to ABI. The entire amount of any gain on property used to produce ABI in a treaty country is treated as exempt surplus. Gains on property used to earn ABI in a nontreaty country are split 50/50 between exempt and taxable surplus, as are gains on shares of corporations, substantially all of the assets of which are used to earn ABI. Gains on shares of other corporations or on property not used to earn ABI are also split 50/50 between exempt and taxable surplus, with the taxable portion included in FAPI.

As a general rule, income from mining will be ABI in most cases, although interpretational issues do sometimes arise. A Canadian mining corporation carrying on operations outside Canada through foreign subsidiaries should be able to defer Canadian taxation of most or all resulting income until those amounts are repatriated to Canada as a dividend. Amounts so repatriated to Canada will be received free of tax as exempt surplus if the foreign undertaking is carried on in (and

¹¹Typically central management and control is considered to be the board of directors of the corporation, although if the directors have no real authority (or habitually do not exercise authority), it may be determined to lie elsewhere.

¹²For a more detailed discussion of these rules, see <http://miningtaxcanada.com/investment-outside-of-canada/>.

Table 4. Overview of Canadian CFC Regime

	FA Resident in and Income Earned in Treaty Country	All Other Cases
Active business income Most business income and certain passive intragroup payments relating to an active business	Exempt surplus Not FAPI	Taxable surplus Not FAPI
Passive income Interest, dividends, rents and royalties (other than recharacterized intragroup payments and dividends from other FAs); also certain business income if <6 employees or principally Canadian-related	Taxable surplus FAPI; if earned by CFA, attributed to Canadian taxpayer and taxed currently	

the FA is resident in) a treaty country. Otherwise, income paid back to Canada from active projects conducted by FAs in nontreaty countries will be taxed in Canada with relief provided for foreign taxes paid.

C. Planning for Foreign Affiliates

Planning for activities of FAs is a complex issue, and in many instances the primary driver is management of local taxes and legal issues rather than Canadian taxes. It is possible to make some general observations, however.

It is typically advantageous to interpose one or more holding corporations between the Canadian taxpayer and the local operating subsidiary, for several reasons (illustrated in Figure 2):

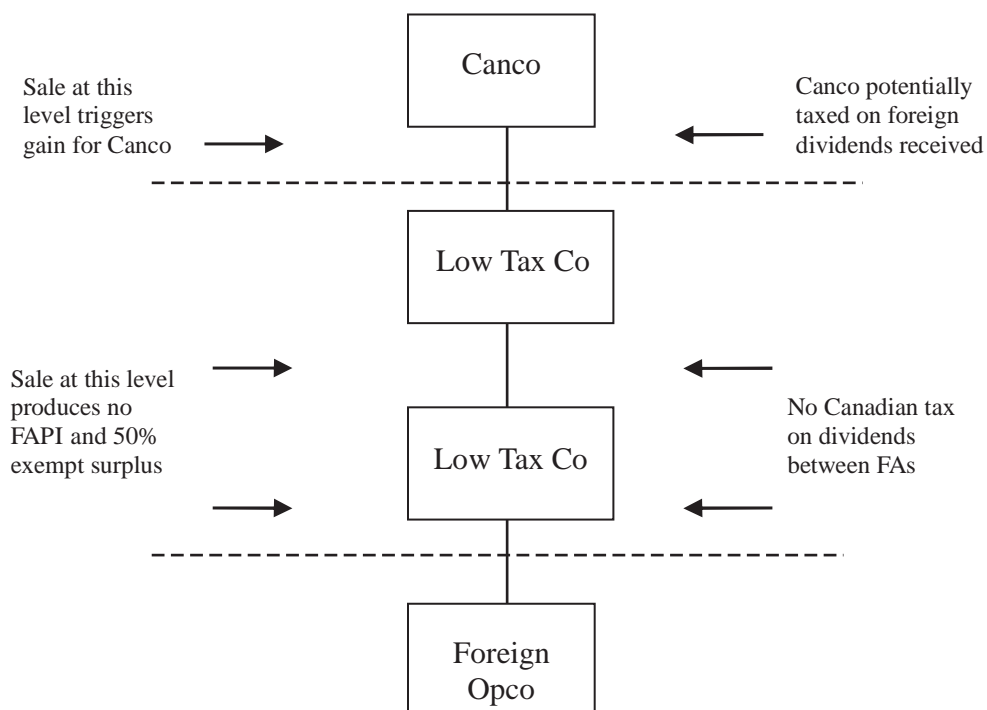
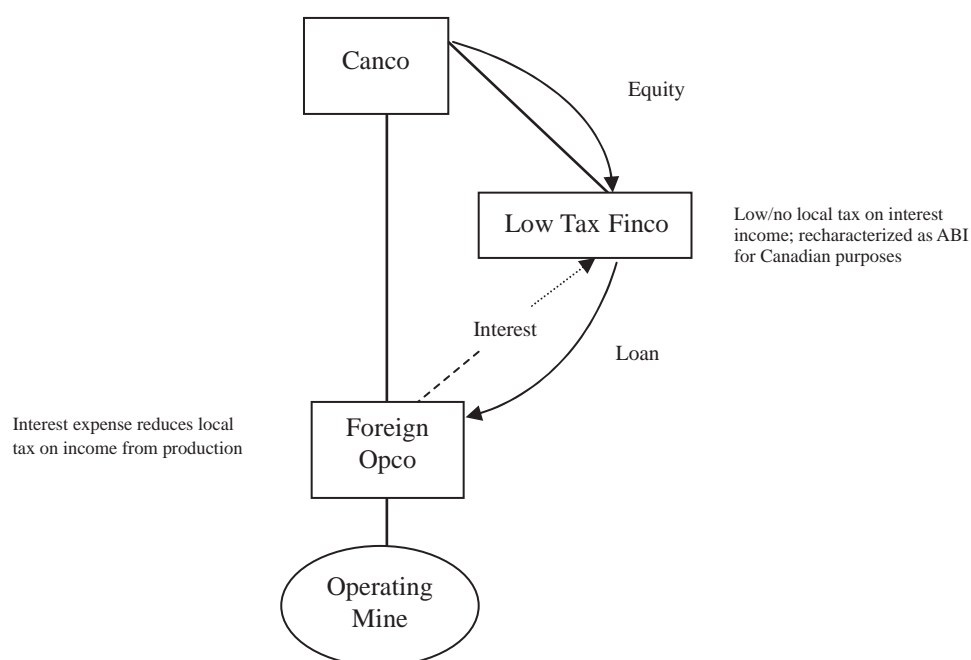
- The sale of a local operating entity held directly by a Canadian resident would produce a capital gain taxable in Canada, but if the same sale was made by a foreign holding company there would typically be no Canadian tax (and 50 percent exempt surplus).
- Similarly, dividends received by a Canadian corporation from an FA may be taxable unless derived from the FA's exempt surplus or (if from taxable surplus) there is sufficient underlying foreign tax to shelter the amount of the dividends. Conversely, dividends paid by an FA to a foreign holding company result in no Canadian tax and simply move a corresponding amount of the payer's exempt or taxable surplus to the recipient.
- Holding companies offer the opportunity to access a third-country tax treaty into the local operating jurisdiction, which may be more advantageous than the corresponding Canadian treaty.
- When there are foreign operating entities in multiple countries with varying tax rates, the use of an intervening holding company as a "mixer" can optimize the use of credits for underlying foreign taxes under the FA rules.

The use of foreign holding companies to minimize tax leakage (Canadian and foreign) is especially important in capital-intensive industries such as mining, where funds from one project often have to be redeployed within the foreign group to finance others.

Tax-effective financing of foreign affiliates depends on a number of factors, many of them unique to the particular jurisdiction in which mining operations are located. A common financing strategy for Canadian parent companies is the use of the rule that allows passive income such as interest to be recharacterized as ABI when incurred on an interaffiliate payment relating to ABI of a group member. For example, as shown in Figure 3, when Canco puts equity into a financing subsidiary that lends these funds to a group member earning ABI such as income from mining operations, the interest on the loan is typically deductible to the debtor under local law, is not treated as FAPI for Canadian purposes because of the recharacterization rule, and generates exempt surplus in the financing subsidiary that can be redeployed within the group or repatriated to Canada free of tax. There are several potential variations of this basic concept.

V. Nonresident Investment in Canada

With so many Canadian-based mining corporations and an abundance of natural resources located within the country, it is no surprise that nonresidents are major investors in Canadian mining. Canada is quite an open market in terms of nonresident investment. While a statute regulating significant nonresident investment exists (the current review threshold is C \$300 million, scheduled to be raised to C \$600 million), rejection of foreign investment is exceedingly rare. Anticompetition regulatory approval may also be necessary, depending on the facts. There are no capital controls or stamp duties. Note that when direct or indirect interests in Canadian mining assets are being acquired from a vendor that is a nonresident of Canada, the purchaser may have an obligation to withhold and remit a portion of

Figure 2. Use of Outbound Holding Companies**Figure 3. Financing of Foreign OPCO**

the purchase price to the CRA on account of the purchaser's Canadian tax obligations.¹³

A. Form and Structure of Investment

A threshold-level issue for a nonresident investing in Canada is whether to purchase assets or interests in the entity owning those assets (for example, shares of a corporation). Direct purchases of Canadian mining assets by nonresidents are relatively unusual in Canada for a variety of tax and nontax reasons, and many Canadian mining companies have primarily foreign mining assets. It is much more common for nonresidents to either acquire Canadian mining assets through the use of a Canadian acquisition company or to acquire shares of Canadian mining corporations. A nonresident acquiring Canadian mining assets directly will be subject to regular Canadian income taxes (and provincial mining taxes in the case of operating mines) on income from those assets.

For transactions structured as a purchase of shares of a Canadian corporation, a nonresident will typically use a Canadian subsidiary of itself as the actual purchaser of the Canadian target's shares. The use of a Canadian acquisition corporation (Bidco) has a number of potentially beneficial Canadian tax effects, including:

- maximizing the paid-up capital (PUC, the tax version of corporate-law stated capital) of the top-tier Canadian entity, which can be paid out to the foreign parent without incurring Canadian dividend withholding tax;
- making possible the step-up or bump in the cost for tax purposes of the Canadian target's property noted below in Section V.D.; and
- potentially consolidating the tax-deductible interest expense on any acquisition debt incurred by Bidco with the taxable income earned by the Canadian target, by merging the Canadian target into Bidco (while Canada has no system of consolidated group relief, the ITA permits amalgamations of Canadian corporations to occur on a tax-deferred basis).

B. Form of Consideration

Vendors selling shares of a Canadian mining corporation generally receive the purchase price in the form of cash, shares of the purchaser, or a combination thereof. A vendor of property can receive shares of a Canadian corporation on a tax-deferred basis under the ITA as full or partial payment for the sale price. Vendors receiving exclusively cash or shares of a nonresi-

dent purchaser will realize any accrued gains on the property they sell for Canadian tax purposes.

In response to this, foreign purchasers using their share as consideration in an acquisition and wishing to provide tax deferral to vendors for Canadian tax purposes often use an acquisition structure known as exchangeable shares, under which vendors exchange property for shares of a Canadian subsidiary of the foreign purchaser, structured to defer the vendor's accrued gain. These shares of the Canadian subsidiary are exchangeable on demand for shares of the foreign purchaser, at which time deferred gains will be realized for Canadian tax purposes. Exchangeable shares have been used in a number of large inbound Canadian acquisitions, including in the mining sector.¹⁴

In addition to their shares being ineligible to be received on a rollover basis by vendors, foreign purchasers have another disadvantage relative to Canadian purchasers in that if vendors receive shares of a foreign purchaser, this will generally render the transaction ineligible for the tax cost bump described below in Section V.D.

C. Capitalization

The basic Canadian tax elements of debt and equity financing have been described in sections III.A. and III.B. of this article. When arm's-length debt (for example, bank financing) is being used as part of the acquisition financing, consideration must be given as to where to locate the debt to maximum advantage. Bank debt incurred by Bidco will not be subject to Canadian nonresident withholding tax or thin capitalization restrictions.

Conversely, if bank debt is incurred at the foreign parent level, the interest expense will not be deductible against taxable income in Canada unless funds are in turn loaned by the foreign parent to Bidco. Interest paid by Bidco to a related foreign lender will be subject to Canadian withholding tax (unless paid to a U.S. creditor so that the exemption in the Canada-U.S. treaty applies) and be subject to the 2-1 debt-equity limitation on deductibility.¹⁵ More complex techniques such as hybrids may permit interest deductibility at both the foreign parent and Bidco levels, depending on the circumstances. The potential for Canadian interest withholding tax typically encourages the use of a foreign group creditor (either the foreign parent or a separate finance company) located in a tax treaty jurisdiction to obtain a 10 percent rate, depending on the

¹³This subject is discussed in detail in Suarez and Gaskell, "Canada's Revised Section 116 Regime for Nonresident Vendors," *Tax Notes Int'l*, Jan. 26, 2009, p. 321, *Doc 2008-27299*, or 2009 *WTD 16-10*.

¹⁴See Suarez and Samtani, "Using Exchangeable Shares in Inbound Canadian Transactions," *Tax Notes Int'l*, Dec. 24, 2007, p. 1281, *Doc 2007-25892*, or 2007 *WTD 248-9*. Hemlo-Battle Mountain is an example of a mining sector exchangeable share deal. Vivendi's acquisition of Seagram and the merger of Molson and Coors were also done via exchangeable shares.

¹⁵Note that only debt owing to specified nonresidents counts toward the debt limit, not external bank debt.

extent to which Canadian withholding tax is fully creditable in the lender's home country. As Canadian taxes must generally be computed in Canadian dollars for ITA purposes, consideration should be given to potential foreign exchange gains and losses in capitalizing Bidco, for both debtors and creditors.¹⁶

The equity portion of Bidco's capital will typically be held by a foreign parent located in a tax treaty country to obtain the lowest possible Canadian dividend withholding tax rate and favorable treatment of capital gains on sale (discussed in Section V.D., below). Luxembourg is a common choice for many foreign investors into Canada. Note that unlike the United States, there is no rule deeming equity distributions to come first from earnings and profits so as to be taxed as dividends. Subject to a solvency test and the presence of sufficient PUC, Bidco can choose to make a distribution on its equity as a return of PUC, which simply reduces the shareholder's cost of the share for Canadian tax purposes. The ability to distribute property out of Canada free of tax as a PUC reduction makes PUC a valuable attribute.¹⁷

D. Planning Issues

There are other tax planning issues that must be considered before the investment is made in order to be managed properly. As always, taxpayers should make every effort to conduct their affairs so as to maintain lawyer-client privilege over all planning materials and communications, which prima facie apply to communications involving a lawyer and client (no accountant-client privilege exists in Canada). This protection from disclosure is helpful in allowing investors to obtain a candid assessment of the risks and benefits of different planning possibilities without fear of the CRA drawing untoward conclusions from advice or communications that represent work in progress or are not worded as precisely as would materials prepared for an external audience.

1. Target Losses and Resource Pools

A purchaser is significantly constrained in its ability to use the losses of a corporation of which it has acquired control. Effectively, an acquisition of control of a corporation occurs when there is a change in the direct or indirect shareholdings of the corporation so that a different person or group of persons unrelated to the current controller has de jure control of the corporation (that is, the ability to elect the majority of the corporation's board of directors).

If control of a corporation is acquired, its tax year is deemed to end, and any accrued but unrealized losses on most forms of its property (including depreciable property) are deemed to be realized immediately before that year-end. The corporation's unused non-capital (that is, operating) losses from a business arising in preacquisition of control tax years can be carried forward and used in postacquisition of control tax years (and vice versa) only if both:

- throughout the later year in which it seeks to use the loss the corporation continues to carry on with a reasonable expectation of profit the same business that gave rise to the loss; and
- the income against which the loss is used arises from carrying on either the business that generated the loss or a business of selling similar properties or rendering similar services as were sold or rendered in the loss business.

These rules are illustrated in Figure 4.

Thus, for example, a mining company cannot acquire control of a software company and expect to be able to use the latter's losses incurred before the acquisition of control against future mining income. The CRA has ruled favorably, however, that different minerals are "similar properties," so that losses from mining gold, for example, incurred before the acquisition of control could be used against income earned after the acquisition of control from mining another mineral such as uranium.¹⁸ Capital losses of the target and its subsidiaries do not survive an acquisition of control, although a one-time election is permitted to apply them to offset accrued and unrealized capital gains on whatever property they own at the time control is acquired. Since planning is required to use losses in one entity against accrued gains in another (Canada has no consolidated group relief system), cooperation of the vendor in undertaking such planning before the acquisition of control is often helpful.¹⁹

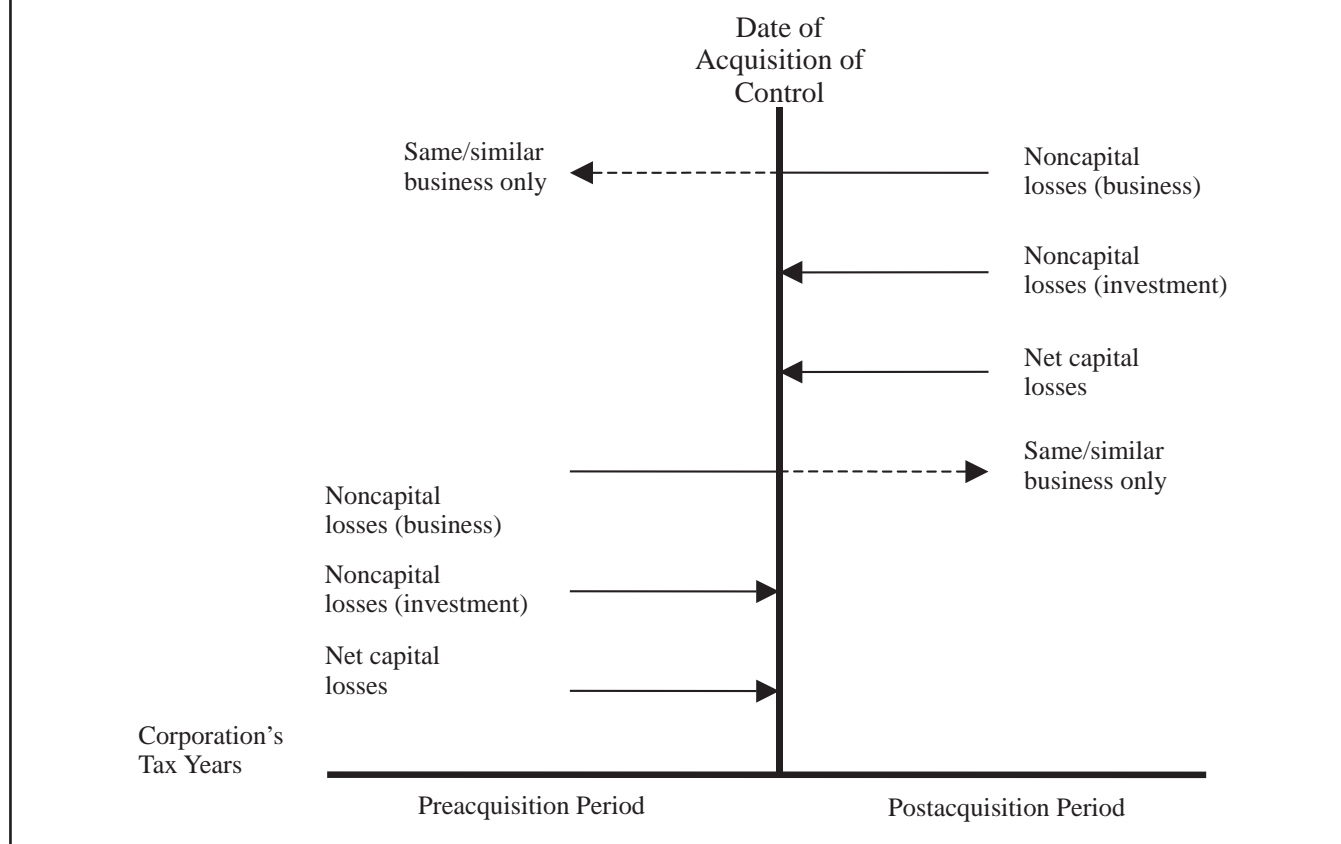
Somewhat similar rules apply regarding CCEE and CCDE of a mining corporation that undergoes a change of control. When a corporation (the successor) acquires all or substantially all of the Canadian resource properties owned by another person (the predecessor) and the parties so elect, the successor rules apply in a taxpayer-friendly fashion to allow the successor to inherit the predecessor's unused CCEE and

¹⁶This is addressed in Suarez and Beswick, "Canadian Taxation of Foreign Exchange Gains and Losses," *Tax Notes Int'l*, Jan. 12, 2009, p. 157, *Doc 2008-26103*, or *2009 WTD 9-17*.

¹⁷This is explained in greater detail in Suarez and Woolees, "Ten Essential Elements of Canada's Tax System," *Tax Notes Int'l*, Sept. 8, 2008, p. 825, *Doc 2008-17137*, or *2008 WTD 177-11*.

¹⁸CRA document 9705947 (Mar. 24, 1997). In the same document, the CRA extended this position to metallurgical coal and other metals (such as base and precious metals).

¹⁹These rules are discussed in Suarez, "Tax Planning With Losses in Canada," *Tax Notes Int'l*, Aug. 1, 2005, p. 451, *Doc 2005-11065*, or *2005 WTD 148-12*. While the Department of Finance expressed a willingness to institute a group relief system in the 2010 federal budget, there does not appear to have been any significant progress toward this so far. See Suarez, "Tax Executives Urge Group Loss Relief for Canada," *Tax Notes Int'l*, Oct. 25, 2010, p. 231, *Doc 2010-22516*, or *2010 WTD 201-3*.

Figure 4. Acquisition-of-Control Loss Restrictions

CCDE balances for use against future income *only* from the acquired properties. When a corporation undergoes an acquisition of control, the successor rules apply in a restrictive manner: The corporation is deemed to be a successor of itself, so that the future use of its CCEE and CCDE pools is restricted to income from (or from the sale of) the Canadian resource properties it owned at the time control was acquired. This prevents an acquirer from using the target company's CCEE/CCDE pools to shelter income from the acquirer's own activities, and is more restrictive than the rules governing loss carryforwards in that they are tied to income from specific properties. Various planning techniques exist for managing the practical effects of the successor rules.²⁰

2. Bump in Tax Cost of Target Property

The step-up or bump in the cost of property for tax purposes afforded by paragraph 88(1)(d) of the ITA is a tax planning tool that is of particular use when ac-

quiring a Canadian mining corporation. It has been used frequently in mining acquisitions, most notably in Barrick Gold Corp.'s 2006 takeover bid for Placer Dome Inc. In this transaction, Barrick and Goldcorp Inc. agreed that if Barrick could acquire Placer Barrick would sell to Goldcorp over \$1 billion of Placer's property. These sale proceeds from Goldcorp effectively funded part of Barrick's purchase price payable to Placer shareholders, and obtaining the step-up in tax cost on the property to be sold so as to eliminate tax on accrued gains was a critical element of the bid.

When an acquirer purchases shares of a corporation, the only tax recognition that the acquirer receives for the purchase price is in the basis (adjusted cost base (ACB)) of the target corporation's shares. If that target corporation is later wound up or merged into the acquirer (as often occurs), these shares disappear, and with them the acquirer's tax recognition of the purchase price. Paragraph 88(1)(d) of the ITA is a relieving provision designed to mitigate some of the harshness of this result. Essentially, this provision allows a Canadian corporate acquirer to increase the ACB of nondepreciable capital property it acquires when a target Canadian corporation is wound up or merged into it. For example, if Bidco pays \$100 to acquire all the shares of

²⁰The successor corporation rules can be quite complex, and are reviewed extensively in Gamble, *supra* note 4, and in Carr and Sanderson, *Canadian Resource Taxation*, Carswell (loose leaf).

a Canadian target corporation (Canco) that has \$100 worth of nondepreciable capital property with \$60 of ACB in it, paragraph 88(1)(d) of the ITA allows Bidco to liquidate Canco on a tax-deferred basis, acquire its property, and potentially increase the basis in that property to \$100. Bumping the ACB of property and eliminating any accrued gain on it allows it to be transferred freely without fear of creating capital gains and accompanying tax.

While the principle behind the tax cost bump is simple, there are several important requirements that must be observed to claim it:

- Both Bidco and Canco must be taxable Canadian corporations, that is, Canadian incorporated and resident (hence the benefit of using a Canadian acquisition company).
- The only property eligible for this step-up in ACB is Canco's nondepreciable capital property. In most cases, this means land and interests in other entities (for example, shares of subsidiaries or partnership interests) but not interests in Canadian or foreign resource properties, buildings, equipment, or inventory.
- Only property owned by Canco at the time that Bidco acquired control of it is eligible for this increase in ACB.
- The ACB of an eligible property cannot be increased above its fair market value. In the case of shares of a first-tier foreign affiliate of Canco, draft amendments to the ITA designed to prevent duplication in ACB and surplus accounts will reduce the maximum addition to ACB and make the bump less generous.²¹
- There are many complex provisions designed to prevent Bidco from selling Canco property back to former Canco shareholders, directly or indirectly, to prevent the use of the bump on what is a de facto divisive reorganization. These rules in particular are overly broad and can add a great deal of complexity to a bump transaction, and they can disallow selling shareholders from receiving shares of a non-Canadian corporation as consideration (foreign purchasers using the bump are restricted to using cash purchase proceeds).

The total amount by which the ACB of all eligible assets may be increased is limited to the following amount:

²¹Essentially, the maximum bump permitted will be the excess of the fair market value of the FA's shares over the sum of their pre-bump ACB and the FA's tax-free surplus balance (basically the amount that the FA could distribute to Canada tax free using exempt surplus and credit for underlying foreign tax on taxable surplus).

Table 5

ACB of Bidco's Canco shares	—	ACB of Canco's assets (net of Canco's liabilities and certain reserves)	—	dividends paid by Canco to Bidco
-----------------------------	---	---	---	----------------------------------

The paragraph 88(1)(d) bump is particularly useful when some Canco assets will be sold immediately following the acquisition of Canco, either elsewhere within the foreign parent group or to a third-party buyer (as in Barrick/Placer). In the example in Figure 4, Canco owns shares of a foreign subsidiary that have accrued gains and constitute nondepreciable capital property (that is, bump-eligible property). By using a Canadian acquisition corporation (Bidco), the foreign purchaser is able to acquire Canco, amalgamate Canco into Bidco, and step up the ACB of the shares of the foreign subsidiaries to their FMV. This in turn allows them to be disposed of without any gain being realized for Canadian tax purposes,²² which would be helpful in either a Barrick/Placer type acquisition (that is, sale to a third party) or on an internal restructuring. For example, Foreignco will often want to extract Canco's FAs from Canada by causing Bidco to distribute them, either as a repayment of acquisition debt or as a PUC reduction (the latter would affect Bidco's thin capitalization debt-equity ceiling).

There are often helpful planning strategies available when Canco is willing to cooperate with Bidco by pre-packaging or restructuring its property before the acquisition of control in order to maximize the usage of the paragraph 88(1)(d) bump. This would permit the ACB of the subsidiary's shares to be increased, effectively allowing the mine to be sold or moved elsewhere within the group.²³

3. Repatriation of Funds Out of Canada

It may be desirable to repatriate surplus cash from Canada. In many cases, choosing the form of distribution will be driven as much by the tax law of the recipient's jurisdiction as the Canadian tax law. Thus, it is important to consider at the outset how funds will be repatriated from Canada, and whether the use of an entity in a particular country is helpful, in terms of both its local law and its tax treaty with Canada. The three basic ways of repatriating cash from a Canadian subsidiary (apart from paying interest on debt) are:

²²Under the draft ITA amendments described above, this may also require the use of the FA's surplus accounts to eliminate accrued gains.

²³See Suarez, "Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know," *Tax Notes Int'l*, Dec. 4, 2006, p. 779, Doc 2006-21865, or 2006 WTD 237-7.

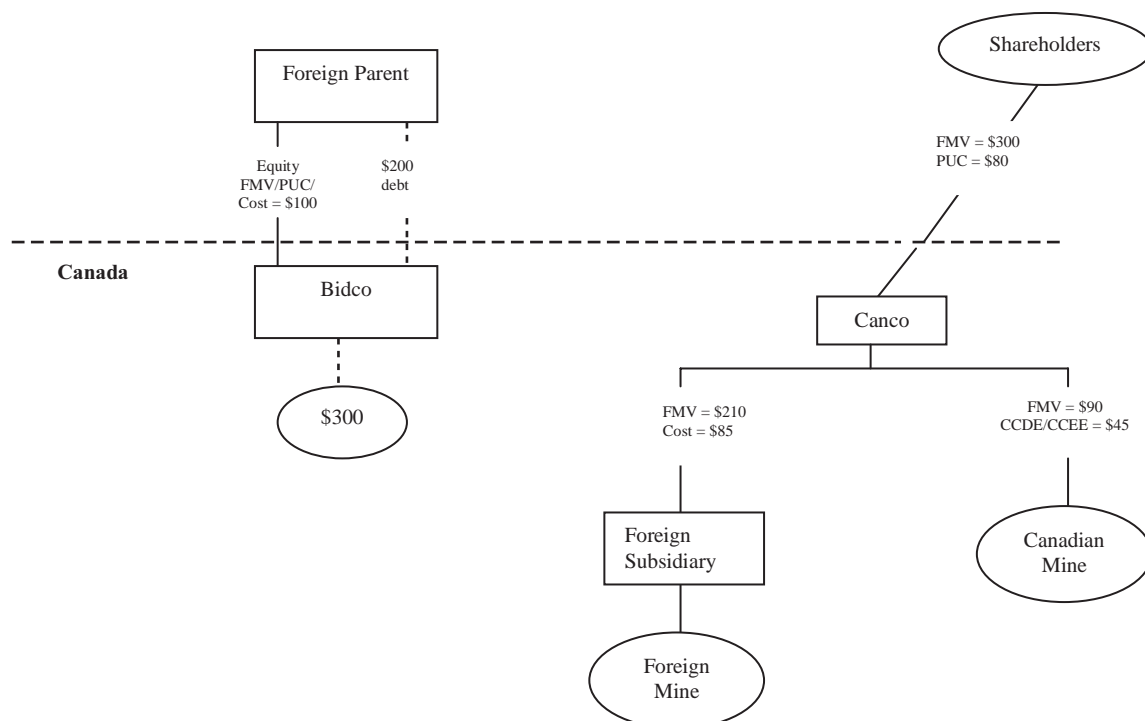
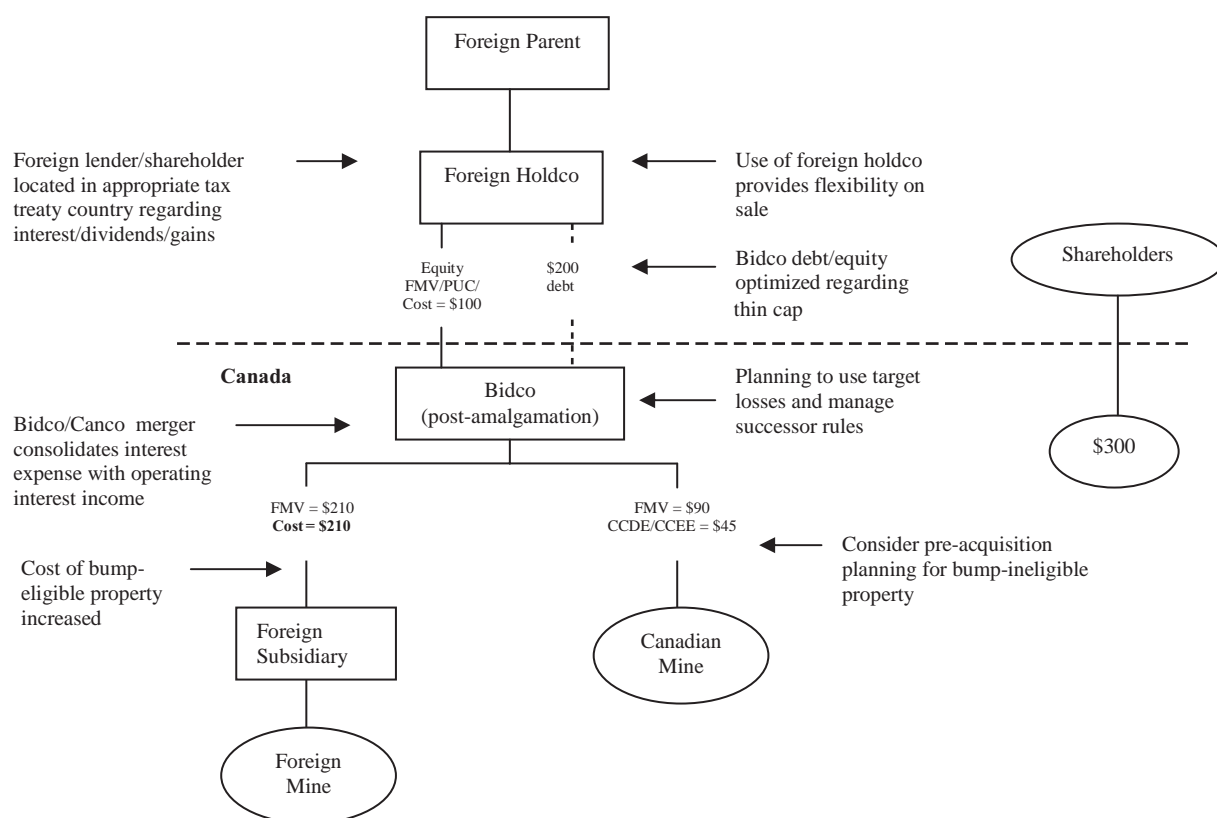
Figure 5. Illustration of Inbound Acquisition Planning**Pre-Acquisition****Post-Acquisition and Bump**

Table 6. Comparison of Repatriation Options

	Dividend	PUC Reduction	Loan
Withholding Tax	25 percent; potentially reduced as low as 5 percent by tax treaty (note Canada-U.S. problem with unlimited liability corporations)	None if sufficient PUC; reduces basis in shares of payer	None if repaid within permitted time frame and not part of a series of loans and repayments; otherwise treated as a dividend
Comments	Consider whether relevant Canadian corporate law places any constraints on Canco's ability to declare and pay dividend (e.g., solvency test)	No U.S. style E&P rule; can choose to reduce PUC even if profits exist Consider effect on thin capitalization rules to Canco	Various rules require market interest rate to be charged by Canadian lender

- The payment of a dividend by the Canadian subsidiary, which gives rise to nonresident withholding tax (reduced to 5 percent for closely held subsidiaries under most Canadian treaties).
- A distribution of PUC by the Canadian subsidiary, which reduces the shareholder's basis in its shares for Canadian purposes.
- A loan by the Canadian subsidiary to the foreign parent. There are a variety of rules dealing with loans to foreign group members, which can be summarized as:
 - requiring an arm's-length rate of interest to be charged; and
 - treating the loan as a dividend unless it is repaid within a specified time frame.²⁴

Depending on the circumstances, intragroup fees for bona fide services rendered to the Canadian entity (for example, management fees or guarantee fees) may also be a useful means of repatriation that are tax-deductible in Canada. The principal forms of distribution are summarized in Table 6.

4. Exit

Finally, at the outset, consideration should be given to what any likely exit strategy will be. Such planning undertaken before the investment is made is helpful in terms of minimizing Canadian and foreign taxes on a sale of the Canadian investment. The Canadian experience to date has been that presale planning undertaken at the time of the initial investment will generally be respected by the courts.

As noted above, for a variety of tax and nontax reasons, nonresidents investing in the Canadian mining sector generally do so through shares of a corporation rather than by a direct acquisition of mining properties. Subject to the critical issue of treaty relief (dis-

cussed below), the ITA taxes nonresidents on capital gains from the disposition of shares of corporations (Canadian or foreign) only when the shares have, at any time in the preceding 60 months, derived more than half of their value directly or indirectly²⁵ from real property in Canada or Canadian resource properties.²⁶ Thus, investments in Canadian mining companies are much more susceptible to Canadian capital gains taxation than are investments in most other businesses.

This makes the role of tax treaties especially important for mining investments. Canadian tax treaties approach the taxation of gains on shares that derive their value principally from Canadian real property (which includes mining properties)²⁷ in different ways:

- *No Relief*: In a relatively small number of treaties there is essentially no relief from Canadian taxation of capital gains (for example, Argentina, Australia, Brazil, Chile, India, and Japan).
- *Taxed if Derived Primarily From Canadian Real Property*: In some cases (for example, China, Cyprus, and Singapore) the treaty simply allows Canada to

²⁵Other than through entities interests in which are themselves not taxable Canadian property.

²⁶If the shares in question are listed on a designated stock exchange, a further prerequisite to Canadian taxation exists: 25 percent or more of any class of the corporation's shares must have been owned by the vendor (including shares held by any non-arm's-length persons) at any time in the preceding 60 months. See Suarez, "Draft Legislation Would Fix Nonresident Tax Trap," *Tax Notes Int'l*, Sept. 27, 2010, p. 1009, *Doc 2010-20624*, or *2010 WTD 183-5*.

²⁷While there are some interesting differences in the definition of real property among Canada's tax treaties, from an inbound perspective these are largely (though not entirely) rendered moot. The Income Tax Conventions Interpretations Act (section 5), which governs the manner in which Canada interprets tax treaties, makes clear that Canada interprets "real property" and "immoveable property" in Canada to include rights to explore for or exploit (or rights computed by reference to production from) mineral deposits, sources, and natural resources in Canada.

²⁴These are discussed further in Suarez and Woolees, "Multinational Groups With Canadian Members in Hard Times," *Tax Notes Int'l*, July 20, 2009, p. 225, *Doc 2009-10831*, or *2009 WTD 136-11*.

tax a corporation's shares if the value of such corporation's *assets* consists primarily (directly or indirectly) of real property in Canada, or if the corporation's *shares* derive their value primarily from real property in Canada (for example, Ireland, Korea, and United Arab Emirates).²⁸

- *Operating Mines Excluded From Real Property:* A large number of treaties use the same "primarily derived from Canadian real property" test, but effectively exempt gains on the shares of operating mining companies by excluding property in which the corporation carries on its business from the definition of real property (for example, Bulgaria, France, Germany, Kuwait, Luxembourg, Mexico, the Netherlands, Norway, Peru, South Africa, Sweden, Switzerland, and the United Kingdom). The CRA has confirmed on several occasions that such treaties exclude Canadian taxation of gains on interests in entities that derive their value principally from mines, mineral reserves, processing mills and related land, buildings, and equipment in Canada through which the entity carries on a mining and processing business.²⁹
- *Taxation Limited to Canadian Corporations:* Several treaties (for example, Bulgaria, Germany, the Netherlands, Russia, South Africa, Sweden, Switzerland, and the United States) effectively preclude Canada from taxing gains on shares of corporations not resident in Canada, even if deriving their value primarily from Canadian real property.
- *Publicly Listed Shares Excluded:* In a number of treaties, Canadian tax is not permitted on gains on shares that are listed on an approved stock exchange located in Canada (for example, Algeria, Bulgaria, Germany, Luxembourg, South Africa, Sweden, and Switzerland) or in some cases either Canada or the other treaty country (for example, Ireland, Kuwait, the Netherlands, and the United Kingdom).³⁰
- *Ownership Threshold:* Some treaties (for example, Bulgaria, Germany, Luxembourg, the Netherlands, Russia, South Africa, Sweden, Switzerland, and the United Kingdom) allow Canada to tax gains on shares that derive their value primarily

from Canadian real property only when the holder meets a minimum percentage ownership level (often but not always 10 percent of any class of the corporation's shares).³¹ Note that this incremental threshold for real-property-based taxation should not be confused with the rule in a few of Canada's treaties (for example, Korea and Mexico) that allows Canada to tax the vendor's gains on a Canadian corporation's shares (no matter what they derive their value from) if the vendor (together with non-arm's-length persons) has owned 25 percent or more of the corporation's capital at any time during the preceding 12 months.

As a result, with appropriate planning, gains on shares related to Canadian mining properties may be exempt from Canadian tax by virtue of the underlying mining property being used in the corporation's business, the relevant corporation being a nonresident of Canada, the shares being publicly listed, or the shareholding not meeting the required ownership threshold. The foregoing illustrates how important it is to carefully choose the fiscal residence of the shareholder of the Canadian acquisition company (and possibly the shareholder of that shareholder). The use of one or more foreign holding corporations resident in a suitable tax treaty jurisdiction is an important part of the acquisition planning, and to date Canadian courts have taken a relatively benign approach to the appropriate use of third countries with favorable Canadian tax treaties (although the CRA is clearly troubled by what it perceives to be treaty shopping).³² In addition to minimizing Canadian taxation of gains on sale of the investment (and potentially the Canadian reporting requirements accompanying such a sale),³³ such planning offers the flexibility to conduct a sale at a level above the Canadian acquisition corporation.

In situations when a Canadian gain cannot be rendered treaty exempt, the vendor should also consider whether a presale dividend (or deemed dividend) out of

²⁸Note that these two variations of the test could produce different results, depending on the liabilities of the corporation and whether the asset test should be read as one of gross assets or net assets.

²⁹See, e.g., CRA documents FE91_040 and FE91_037.039, dated February 25, 1991; 1999-0010583 and 2000-0022523, dated June 6, 2001; and 9703965, dated June 12, 1997. There is considerable authority that a "mining business" includes situations in which the relevant resource properties are owned by subsidiaries; see, e.g., *Minister of National Revenue v. Consolidated Mogul Mines Limited*, 68 DTC 5284 (S.C.C.).

³⁰In the Canada-Ireland treaty, there must be "substantial and regular trading" of the shares on the exchange.

³¹The threshold in the Russian treaty is 25 percent of the corporation's equity, while in the South African and Bulgarian treaties the test is 25 percent of any class of the issuer's equity.

³²See, e.g., *R. v. MIL Investments S.A.*, 2007 DTC 5437 (F.C.A.), when the use of a Luxembourg holding company resulted in the foreign vendor's Canadian-source capital gain being treaty exempt. The Canada-U.S. treaty is the only one with a comprehensive limitation on benefits article although various Canadian treaties have limited benefit denial rules. It is of course essential to ensure that any shareholder is indeed the beneficial owner of the shares in question and not a mere titleholder or agent, and that it is truly a fiscal resident of the relevant jurisdiction and entitled to benefits under the applicable treaty.

³³A sale by a nonresident of Canada of shares of a corporation (other than shares that are publicly listed) that have derived their value primarily from Canadian real property during the preceding 60 months may create notification and withholding obligations under the section 116 regime; see *supra* note 13.

Canada to the foreign shareholder makes sense. As the rate of Canadian dividend withholding tax (often 5 percent in closely held situations) is typically less than the rate of Canadian tax on capital gains, there may be considerable benefit to such forms of presale planning when circumstances permit, depending of course on the relevant foreign tax treatment.

VI. Conclusion

Mining has been and will continue to be a core component of the Canadian economy and a sector of

tremendous interest to nonresident investors. Taxation is a highly important factor in the continued success of Canadian mining, and in a world of ever-more-mobile tax bases where source-country taxation is becoming increasingly important for revenue-hungry governments, mining taxation represents a key feature of the Canadian fiscal landscape. ♦